Presented by

FT LIVE

In collaboration with

The Banker

CRYPTO: WILL A RESET RESTORE TRUST?

FT Live's roundup of industry developments, risks and opportunities

1 12 MONTHS ON THE CRYPTO ROLLER COASTER

2 AROUND THE CRYPTO WORLD

3 “FINANCE IS ABOUT TRUST, ULTIMATELY”

4 TRADING VOLATILE CRYPTO MARKETS

5 CAN CRYPTO REGULATION BE MADE TO WORK AT A GLOBAL LEVEL?

6 BLOCKCHAIN FOR BANKING - ESSENTIAL OR OPTIONAL?

7 EXPLORING WEB 3.0 AND THE METAVERSE

8 WHAT’S NEXT FOR CRYPTO?

1 12 MONTHS ON THE CRYPTO ROLLER COASTER

Crypto was riding high in the final months of 2021. The mood was optimistic with market participants embracing the promise of financial innovation. New coins were flooding the market, Nonfungible tokens (NFTs) had hit the mainstream, and bitcoin, which reached a record high of US$67,000 in November 2021, was being heralded by investors as the future of money. In the US, the Super Bowl featured advertisements for crypto companies including FTX, crypto.com and Coinbase. And international conferences, including the FT's own Crypto and Digital Assets Summit, hit the market, bringing together the best and brightest in the industry.

> *It's become clear that the concentration of power, coupled with a lack of oversight, has caused massive customer losses, because funds were funnelled around with no accountability.*
>
> Gillian Tett, Financial Times, November 2022

The risks, however, loomed and were exacerbated by the onset of a global economic downturn, and the prospect of greater regulatory scrutiny. As central bankers signalled higher interest rates, crypto prices started to fall and the extent to which the crypto ecosystem was leveraged emerged. By June, Bitcoin had plunged more than 60% from its previous high. Ether was down 73%. This led to a collapse in digital assets erasing about US$2tn from the total market value of November 2021. Digital asset lenders including Celsius Network and Voyager Digital filed for bankruptcy as the crisis deepened.

Contagion spread. Ironically, though the decentralised nature of blockchain and crypto holds the promise that no one player could destabilise the rest, the events of 2022 proved this to be false. The digital asset universe was shown to be tangled and interconnected, with a few large players concentrated at its very core.

> *Crypto assets are potentially changing the international monetary and financial system in profound ways.*
>
> IMF Blog December 2021

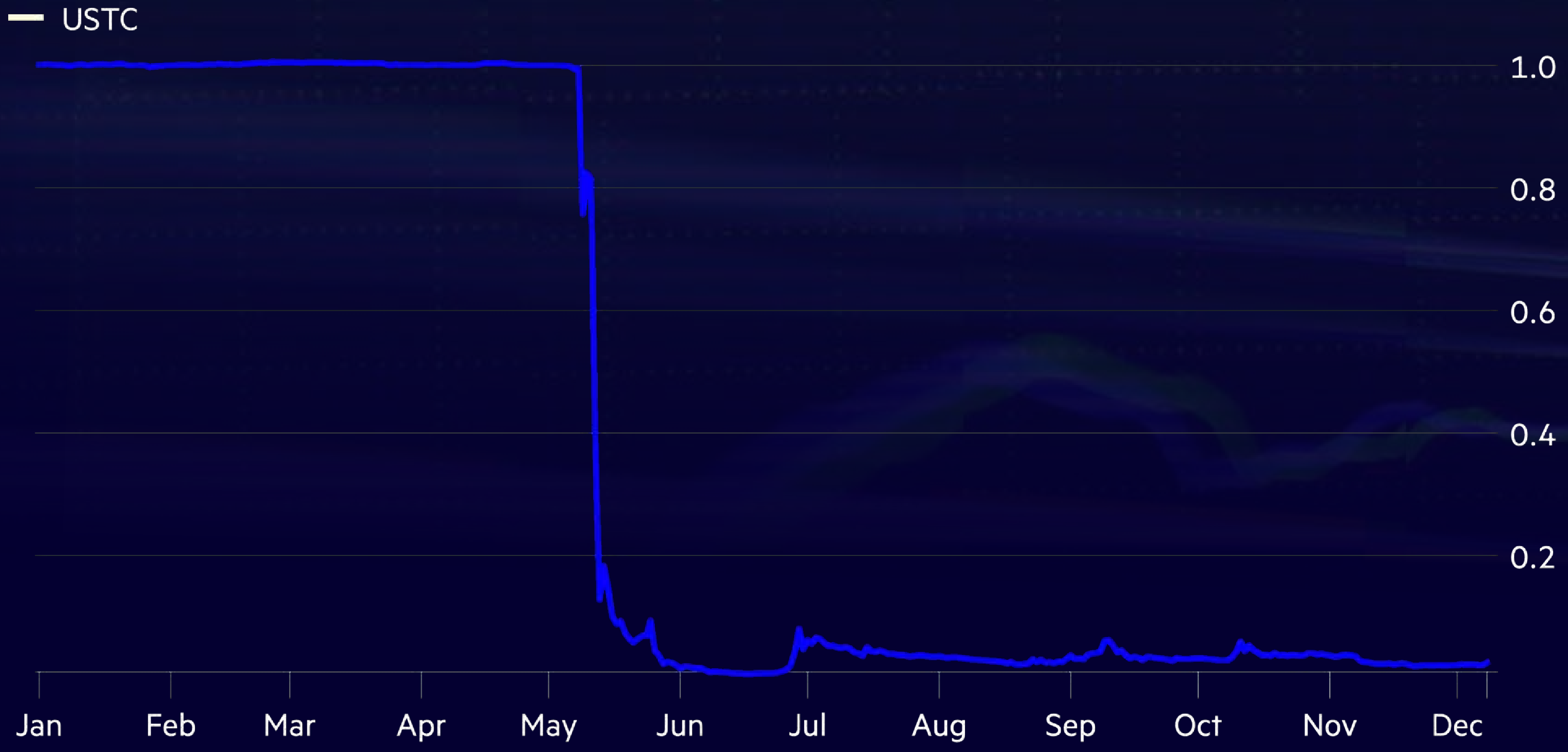
May 2022 saw the implosion of stablecoin terra, which led to the collapse of luna, its sister token, hitting companies with exposure to both.

November 2022 saw the stunning collapse into bankruptcy of FTX in November 2022 which revealed the true fragilities of the crypto-asset market. Valued at US$32bn just 11 months earlier, FTX businesses were found to owe more than US$3bn to their largest creditors including some of the world's biggest institutional investors. CEO Sam Bankman-Fried went from hero, who had lunch with the FT, to zero in a matter of days. The crypto industry's image was in tatters leading anxious investors to rush for the exit and withdraw record amounts from centralised exchanges. It led to an "avalanche of corporate failures", including Genesis Trading.

The ripples, since then, have spread far and wide and resulted in much soul searching among investors, crypto promoters and commentators. Did they get it all wrong? Moreover, what will the demise of crypto friendly Silicon Valley Bank (SVB), Signature Bank and Silvergate Capital mean for the market? Should crypto (partly) take the blame for these events? Does this spell the end for crypto and decentralised finance, or can this industry go back to its roots and emerge again refreshed and clean?

The Terra stable coin's collapse sent shockwaves through the crypto industry

TerraUSD's dollar peg broke in May



Source: CryptoCompare

© FT

> *If you ask enough questions about crypto, or express enough scepticism about its grander claims, the true believers will accuse you of spreading fear, uncertainty and doubt, or "FUD".*
>
> Katie Martin, FT.com, November 2022

> *FTX was the paragon of stability in the crypto market and helped legitimise it as an asset class. That view was endorsed by the who's who of the investment world, and now it has all come undone.*
>
> Financial Times, November 2022

2 AROUND THE CRYPTO WORLD

Crypto is a global phenomenon but around the world the culture and risk appetite of investors, customers and regulators present different approaches to how the assets are viewed and used.

Asia represents the world's third largest cryptocurrency market. Despite the effects of the FTX collapse, investors and regulators across the region remain cautiously excited by the opportunity. There is great interest in the potential of central bank digital currencies (CBDCs) with pilots and trials across the region and in Australia.

- Though China, home to a digital renminbi, banned all cryptocurrency transactions in September 2021, Hong Kong has begun taking steps towards establishing itself as a top Asian crypto hub.
- This will put it in direct competition with Singapore where the MAS says that while it welcomes the "transformative economic potential" of the asset class, it does not support consumer speculation in cryptocurrencies.
- In Japan, an early crypto adopter which has endured hacks and losses, the ruling Liberal Democratic Party Web2 team has said the country "is positioned to play a unique role in the crypto industry"
- And in South Korea where more than 10 percent of the population reportedly holds cryptocurrency, the collapse of FTX took its toll, regulations are tightening, and a tax on crypto gains is planned for 2025.

In **Latin America and the Caribbean** a recent IMF report suggests that there is a "high interest in unbacked crypto assets and stablecoins" across the region. But caution exists about the proliferation of digital assets due to their volatility and potential for criminal use.

- The Bahamas was the first country in the world to launch a CBDC, the sand dollar, with mixed success so far. CBDCs are viewed by some as a route to greater financial integration across the region.
- El Salvador's highly publicised government-backed move to adopt Bitcoin as an official currency has, reportedly, not yet taken off due to the fall in the value of bitcoin, technology issues, and the country's ongoing and severe economic woes.
- Brazil recently legalised crypto as a legal payment method, created a licensing regime for virtual asset service providers and set penalties for digital asset fraud.
- Argentina is among the region's biggest adopters of crypto, due to the instability of the peso, but rumours abound that the government is looking to strengthen regulation of the industry in the coming months.
- Crypto usage is also expanding in other countries including Colombia, Mexico, Panama, Cuba and beyond.

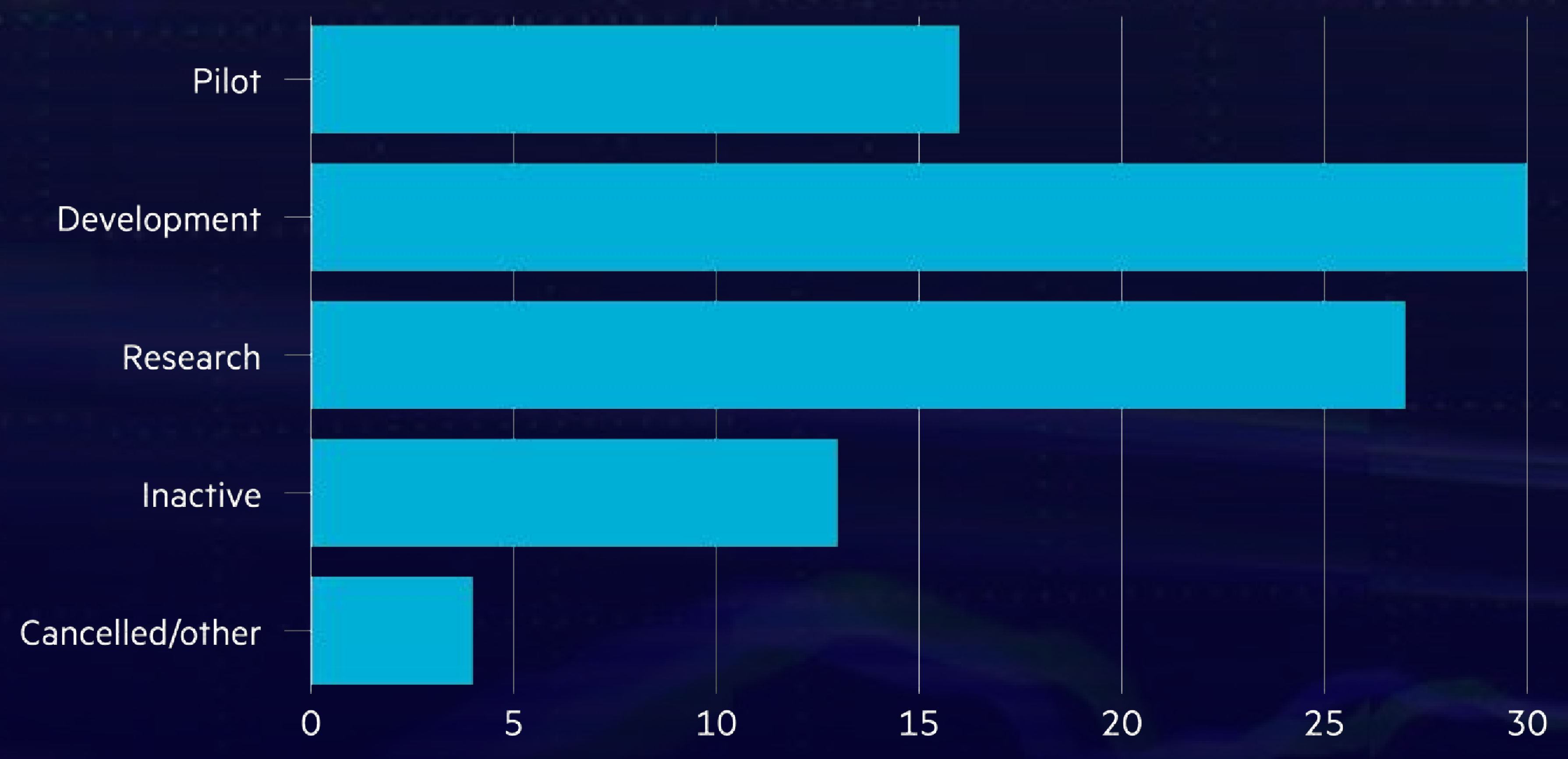
In the **UK and Europe**, regulation, market sustainability, the prospective launch of CDBCs, and the tokenisation of financial services dominate crypto conversations, along with ongoing speculation around the wider business use case for blockchain.

- The FT reported last month that "the competition between the UK and EU to lure crypto business has stepped up a notch" signalling a head to head about which jurisdiction becomes the next global crypto hub.
- The reverberations of the FTX collapse continue to shape the debate about how best to supervise the industry, allowing it room to grow, while simultaneously safeguarding from future implosions.
- As the market matures, increased consolidation between players seems likely, as healthier companies acquire those struggling to plug the gaps in their own capabilities.
- The sustainability of crypto and blockchain will continue to be scrutinised, driven by pressure from consumers and policy makers.
- The prospect of CBDCs seems real in the UK and Europe. According to the European Central Bank, they are "essential in ensuring that public money addresses the preferences and needs of citizens and businesses in an ever evolving digital landscape".
- In the UK, the Bank of England and HM Treasury are actively investigating the case for a digital pound, or Britcoin, as it has been dubbed.

> *We are going to go further, establishing a framework for regulating cryptoassets and stablecoins.*
> **Andrew Griffith**, UK Economic Secretary to the Treasury, *February 2023*

RACE FOR THE FUTURE OF MONEY

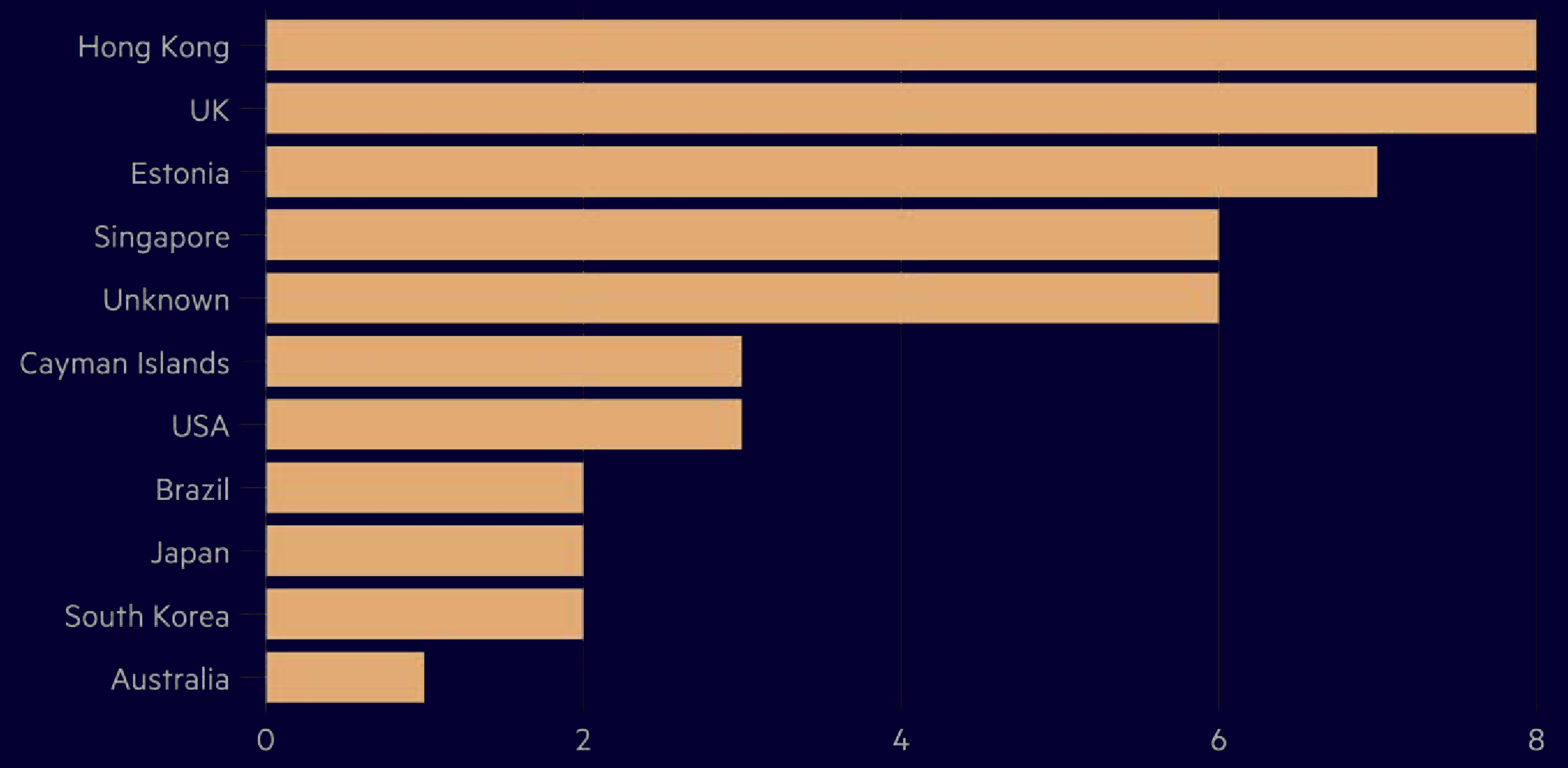
Where the 114 countries stand on CBDC progress in December 2022, %



Development stage includes UK, the US and Europe
Source: Atlantic Council

Crypto exchanges are losing ground in every corner of the globe

The number of crypto exchanges shut down by jurisdiction since June 2019



Source: CryptoCompare
© FT

The fallout from the FTX collapse continues to reverberate across the US as investors and market players nurse their losses, and policy makers scramble to "rein in an industry that until now has largely existed outside the strictures of traditional financial regulation". Whether this regulatory crackdown will help or hinder this evolving industry is as yet unknown.

One negative result so far has been the pull back by Binance on potential investments in the US. A contrasting bright spark on the horizon has been the rally of cryptocurrency-focused ETFs, investments which are described as "high risk and potentially high reward".

The launch of a digital dollar seems possible but remote at the moment. A September 2022 White House report "Technical Possibilities for a Central Bank Digital Currency" said the country has not yet decided if it will pursue a CBDC, and highlighted a number of stumbling blocks around access and technology.

Some markets to watch:

- Dubai is vying with major markets to become the emirate as a global crypto hub and has established what it describes as "the worlds first independent regulator for virtual Assets".
- Chainalysis reports that "Africa contains some of the most well-developed cryptocurrency markets of any region, with deep penetration and integration of cryptocurrency into everyday financial activity for many users". Nigeria and Kenya are identified as leaders.

Recent reports suggest that South Asia accounts for 14% of all cryptocurrency transactions globally. Singapore leads but countries including Vietnam, the Philippines and Thailand are hot on its heels.

> *America's top markets regulator has decided that most crypto companies can't be trusted to look after investors' assets. This is a less-than-shocking conclusion to anyone who's been following crypto markets over the past year. So, therefore, who can be trusted?*
>
> **Scott Chipolina,** FT.com, *February 2023*

3 "FINANCE IS ABOUT TRUST, ULTIMATELY".

Should we let crypto burn? This was the cry of pain after the FTX collapse as fortunes were lost and enthusiasm was replaced with rage. But now that the mood has settled, it's time to ask how crypto can recover its reputation after multiple crises and collapses?

Over the coming months and years there will be much soul searching about where it all went wrong with FTX. Some pointers may be:

- A lack of due-diligence among major firms invested in the exchange.
- The concentration of power among too few large companies.
- The reactive approach of regulators to the industry
- The lack of understanding of the extent to which the crypto assets industry is connected, and in effect centralised.

To rebuild the reputation of the industry, each of these issues, and more, will have to be addressed. There is simply no excuse for a lack of proper due-diligence on the part of major investment firms. And regulators are actively accelerating their plans and priorities on how best to supervise an industry which, at its heart, is designed to exist outside of regulatory control.

> *We need to have comprehensive legislation that assigns regulations the appropriate responsibilities to address the risks that are inherent in these [crypto] networks.*
> **Kristin Smith,** CEO, *Blockchain Association, February 2023, via CNBC.com*

Is it possible for the industry to return to its roots and come back in a simpler, more transparent and less speculative manner? Hyun Son Shin, Economic Advisor and Head of Research for the Bank of International Settlements, addresses this in an FT article in December 2022, suggesting that "this pure form of crypto, which imagines getting rid of centralised intermediaries, would only have a very small footprint". It would only be for enthusiasts rather than being promoted as a prospective part of the financial system.

This rebirth idea seems like wishful thinking, given the current size of the crypto market, and indeed the appetite to see where it can go next. However, there is no doubt that all participants will be proceeding with the utmost caution.

In 2021, Gary Gensler, Chair of the US Securities and Exchange Commission, told the FT that crypto assets are "no different than any others when it [comes] to such public policy imperatives as investor protection, guarding against illicit activity and maintaining financial stability".

It's likely that the continued careful exploration of the use-case for CBDCs, and the outcomes of pilots running across the world, could go a long way to restoring trust in the promise of cryptocurrencies, and indeed blockchain. This is a marathon, not a sprint, and it needs to be based on research and evidence, rather than blind faith or the fear of missing out.   In the words of Gary Gensler "finance is about trust, ultimately"

> *[Crypto] is like any other type of technology, it can always be exploited by bad actors.*
> ***Eun Young Choi,*** Director, *National Cryptocurrency Enforcement Team, US Department of Justice, via: https://govmatters.tv, January 2013.*

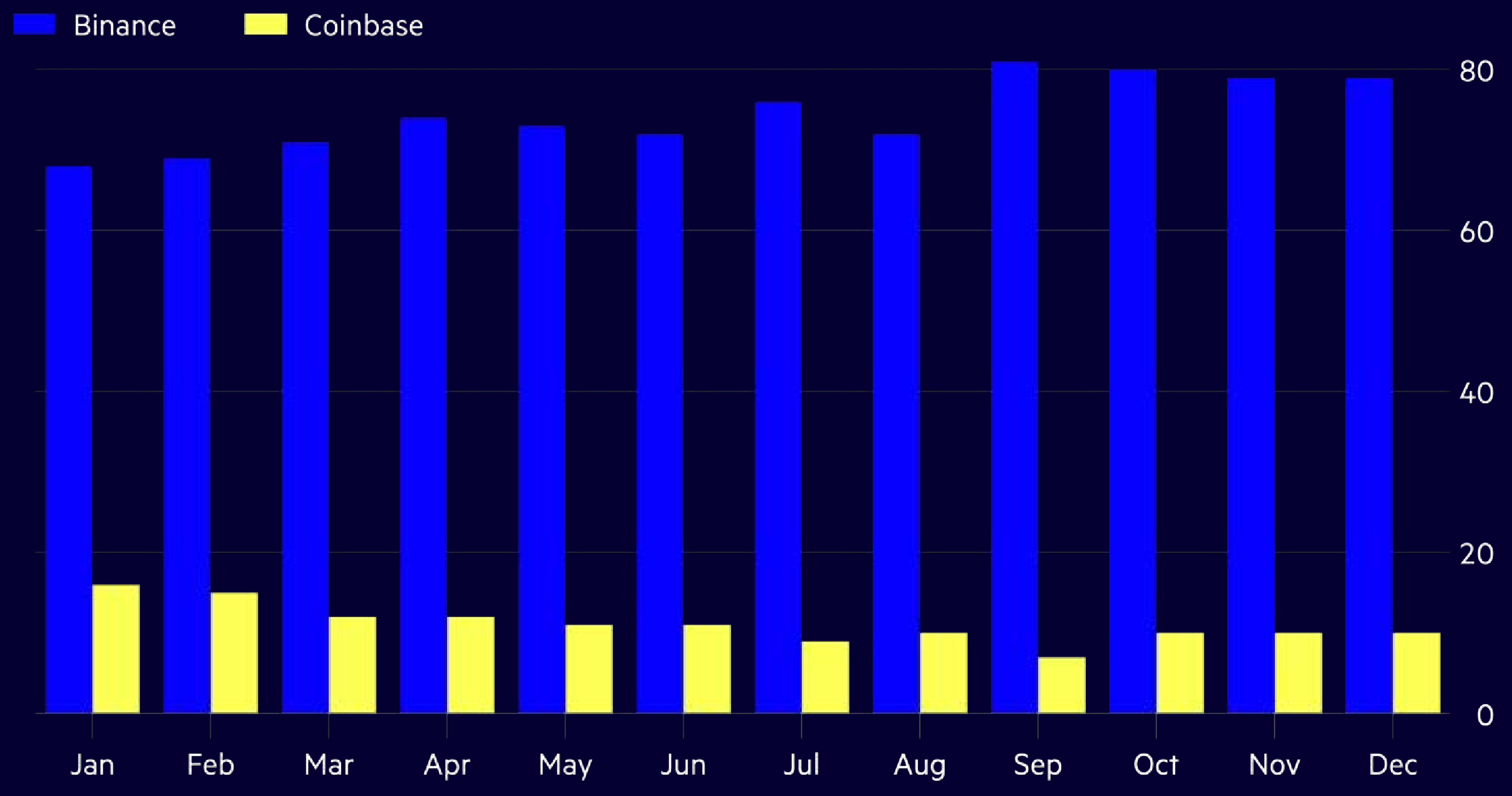
4 TRADING VOLATILE CRYPTO MARKETS

Despite regulatory scrutiny, company collapses, and mixed media coverage, there remains a strong interest and appetite for trading crypto and digital assets. But there is no doubt that investment strategies are adapting as players seek opportunity amid ongoing market volatility.

If the past few months have taught investors anything, it's that crypto investment opportunities are so new, innovative, and often opaque, that they require specific knowledge that even the most sophisticated investors might lack. Matching approaches to indicators such as the Moving Average (MA), the Relative Strength Index (RSI), Bollinger Bands and others is increasingly essential to identify patterns and make predictions about future behaviour.

Market trading for cryptocurrencies has one clear winner

Monthly spot trading market share (%)



Source: CryptoCompare

Crypto market value rises back above $1tn

Market cap of 500 biggest tokens ($bn)

Source: Financial Times Digital Assets Dashboard

It is said that the difference between gambling and trading is strategy! Below are some approaches currently being used to participate in the market:

- Passive trading: trading in crypto derivatives and ETFs has been a bright spark on an otherwise bleak horizon. But will the returns of early 2023 be sustained?

- Scalping: the trading style which profits off small price changes and a quick profit from reselling very quickly is suited to the volatility of current markets but it is not risk free. Using indicators can help gauge market conditions.

- Range Trading - a popular approach to training within a specific price area where the crypto asset trades up and down. Again, the use of indicators is essential to understand where the market is at.

- High Frequency Trading (HFT): a technique where investors use technology to execute trades to profit from price changes occurring in seconds or fractions of sections.

- HODL: buying and holding cryptocurrencies ‘for dear life’ even if markets go down or become volatile. A true believer’s strategy!

- FOMO: Fear of missing out is a feeling rather than a strategy. It shouldn’t really be a consideration for participating in this market!

> “*We’ve seen more of our larger clients eager to onboard and trade with what they probably perceive to be much better regulated and capitalized entities.*
> **Mathew McDermott,** Global Head of Digital assets, *Goldman Sachs, via CNBC’s Crypto World.*”

5 CAN CRYPTO REGULATION BE MADE TO WORK AT A GLOBAL LEVEL?

> *Regulation should foster an environment where good things flourish, and bad things perish.*
> **Hester Peirce,** Commissioner, *US SEC, Jan 2023*

Catalysed by the FTX collapse, and the aftershocks that followed, 2023 so far has been dominated by conversations, statements, rumour and speculation about how regulators will clamp down on crypto assets. Approaches in key markets across the world are as yet still regionally focused, linked by their caution and focus on systemic risk mitigation and investor protection.

- In the UK, measures are aimed at bringing crypto regulations in line with approaches to traditional finance, mitigating the most significant risks while "harnessing the advantages of crypto technologies". They will target financial intermediaries and custodians, and seek to strengthen rules around lending of crypto assets.

> *Global crypto regulation should be comprehensive, consistent and coordinated.*
> *(IMF, December 2021)*

- In the US, President Biden's roadmap to mitigate cryptocurrencies' risks is supportive of the development of cryptocurrencies, yet will aim to protect investors and financial stability, and restrict illegal use. A recent Federal Reserve Board policy largely prohibits digital assets from the regulated banking environment. Combined with the recent enforcement activities of the SEC, some executives "fear the industry is being pushed out of one of its biggest markets".

- The EU will vote on its single pan-European Markets in Crypto Assets (MiCA) Regulation later this year which will bring the crypto asset market under financial services regulation, but aims not to stifle innovation.

- Asia is regulating country-by-country. Hong Kong and Singapore are balancing the need for oversight with the desire to become a crypto hub. Japan is hard on consumer protection but lately has become more welcoming to crypto companies. South Korea is in the process of creating an all-encompassing Digital Asset Basic Act (DABA) to regulate crypto.

> *There are no borders and no barriers to crypto.*
> ***Mairead McGuinness,*** EU Commissioner, *World Economic Forum 2023.*

There is broad consensus on the need for a global regulatory approach to crypto. But it will take time. There are areas of difference to be ironed out around products to regulate, and how to supervise information disclosure and exchange, governance and risk management.

Crypto regulation is on the agenda for discussion at the G20 meetings this year, and has been addressed by the IMF. It is also a priority for the Financial Stability Board, who, it is expected will shortly reveal a timeline for global regulators to implement its steps to regulate the crypto industry. The goal is the creation of a regime where services providers in the crypto industry are held to the same standards as banks, if they provide the same services.

6 BLOCKCHAIN FOR BANKING - ESSENTIAL OR OPTIONAL?

Right now, banks and fintechs are pouring money and time into developing their own blockchain-linked technologies in a bid to ditch the paper and improve their business model as well as reach new markets, expand investment opportunities, and leap ahead of the competition. But is this a must have or a nice to have for this industry?

The jury is out on this, influenced no doubt by the failure of some high-profile blockchain experiments.

- Australian Securities Exchange seven year plan to build a distributed-ledger system to replace its 25 year old clearing and systement system was abandoned when it was deemed too complex and nowhere near completion.
- We.trade, a platform owned by 11 European banks, ran into financial difficulties with suggestions that the trade finance industry was still not ready to embrace the technology.
- B3i, developed specifically to make "insurance more relevant, accessible and affordable through the power of the ecosystem founded on blockchain technology" folded despite consisting of many providers in the re/insurance industry.

On the other hand, among some institutions, there is still a firm commitment to continue exploring the opportunities that blockchain offers.

- In January 2023, the EIB issued its first ever digital bond. This £50mn digital bond "uses a combination of private and public blockchains operated and accessed via HSBC Orion".
- HSBC Orion was launched in late 2022 as a distributed ledger technology bond tokenisation platform. It promises to use Orion to facilitate further digital bond issuance.
- The JP Morgan Onyx Digital Assets platform which allows money market funds to be tokenised linking "other banks and financial institutions such as Visa, and handles payments linked to about US$1bn of assets a day in currencies and bonds".

Overall, it seems too early to assess the extent to which blockchain technologies will integrate into the financial system, or co-exist alongside it. Backed by interest, appetite and a great deal of money, this may turn into a race where only the fittest and well-tested will survive.

> *The excitement from our side is ... seeing how this technology can impact many different parts of the financial system and have a real commercial impact.*
>
> *Mathew McDermott, Global Head of Digital assets, Goldman Sachs, via CNBC's Crypto World*

7 EXPLORING WEB 3.0 AND THE METAVERSE

Web3 and the potential are generating a lot of buzz as they, seemingly, edge towards the mainstream. But what are they and do they have a utility beyond the hype? Or is <u>enthusiasm and investment waning</u>?

Web 3:
At its simplest, Web3 is the next (the third) major evolution of the internet. Some defining characteristics to date include:

- Decentralisation: Web3 will be built with blockchain technology. This, it is believed, will democratise this open Web as control and ownership will lie with the users rather than Big Tech and media giants.

- Permissionless: The network will allow participants to interact directly and without authorisation from any oversight body.

- Artificial Intelligence: Based on Tim Berners-Lee's vision for a Semantic Web, Web3 will use AI and machine learning algorithms to understand information and produce faster, more relevant user content.

The Metaverse
<u>The metaverse</u> is a proposed 3D virtual world, or worlds, where users, represented by avatars, will interact with each other for work, play, shopping, creativity, and more. It has been highly publicised in part because companies like Meta, Google, Microsoft, Nvidia and Qualcomm are pumping billions of dollars into it. Some key aspects of the metaverse include:

- Though they are closely related and hugely hyped, the metaverse is not Web3. One aims to decentralise the internet, the other to create a virtual world.

- Despite the hype, there is, as yet, no agreement on how the metaverse will work. Will it remain niche, or under the control of large organisations, or open and interoperable?

- Crypto tokens, currencies and NFTs have the potential to play a key role in the metaverse.

> *The real world - in all its splendour and spillage - was always going to be a fabulously tough competitor for the virtual one*
>
> **Leo Lewis,** Asia Business Editor, *Financial Times, FT.com, June 2022.*

Despite the excitement, both Web3 and the metaverse are still a work in progress. And, as the tech economy cools, key questions remain about their development and their use-case beyond the hype. Recent trials conducted by UBS and Julius Baer around offering wealth advice in the metaverse suggest the technology and the processes are not yet ready.

Though Web3 will be built using DLTs and blockchains, there is disagreement about whether the same technologies are needed to enable the metaverse. Second Life, for example, runs successfully without using the blockchain. On the other hand would omitting blockchain be a mistake, an missed opportunity to decentralise virtual ownership and control?

A second major issue is the environmental impact of blockchains. Will further promotion of their use in Web3 and the metaverse in fact counteract climate change mitigation?

Both Web3 and the metaverse hold huge promise but it will be important that investors and users step back and judge the landscape for what it is and could be, rather than being influenced by hype. Should we be getting so excited by something so nascent and untested?

> *I believe that the web3 industry offers a once-in-a-generation opportunity to re-shape systems that haven't worked for so many around the world.*
>
> *Sheila Warren, CEO, Crypto Council for Innovation, via LinkedIn*

8 WHAT'S NEXT FOR CRYPTO?

> *A bit more fear, uncertainty and doubt about crypto is welcome*
>
> **Katie Martin,** Markets Editor, *Financial Times, FT.com, November 2022*

Opinion is divided on the outlook for crypto. There is no doubt that the dramatic events of 2022 introduced what the IMF describes as "FUD: fear, uncertainty and doubt" into the market which is currently valued at around US$1tn, down from US$3tn in November 2021. But as the dust settles, sentiment is shifting with the growth of exchange traded products, the inclusion of crypto assets in retirement funds, and ongoing investment in digital assets and blockchain technologies. Have the experiences of the past year informed rather than frightened investors and market players? Has the market hit an inflection point that will guide the next phase of its evolution?

Much will depend on the direction of regulation in the next 12 months. Greater clarity is expected as investors push for enhanced governance and improved standards to mitigate the risks of the asset, and make it safer for everyone to navigate. However, this will take time as different jurisdictions lay down their own rules, and ultimately work towards a global approach. A coordinated international approach seems, at the moment, some way off.

Caution remains the watchword. The collapse of Silicon Valley Bank (SVB), Signature Bank and Silvergate Capital has brought home the continued fragility of the industry and the wider market. On top of that, there is now increased scrutiny on the weaknesses of stablecoins, such as the USDC which broke its dollar peg when its parent company, Circle, revealed a (now rescued) US$3.3bn exposure to SVB.

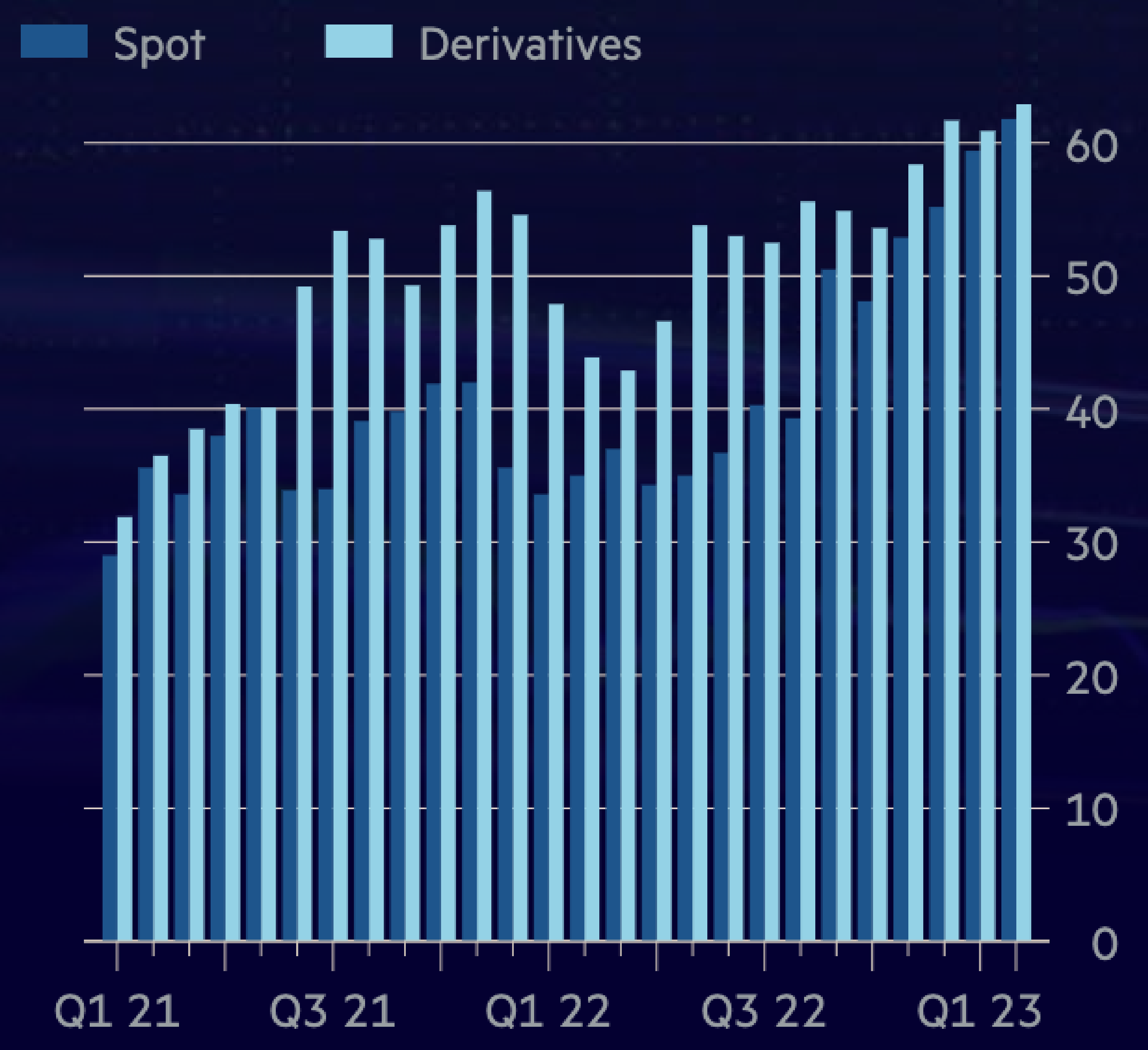
As regulators tighten their grip, all eyes are on the surviving industry participants, and the role that traditional finance and markets might be required to play in their survival. Whether companies like Binance, which is rapidly filling the void left by FTX, will be permitted to continue to dominate this developing and still risky market still remains to be seen.

> *Doing nothing is untenable as crypto assets may continue to evolve despite the current downturn.*
>
> *IMF, February 2023*

Meanwhile, the crypto industry continues to evolve at pace. Tokenisation, Web3, permissioned DeFI, and a greater usage of NFTs are opening up the landscape. The price of bitcoin and ether have rallied, while Tether's stablecoin USDT dominates that market. Investigation of the potential for CBDCs such as the Britcoin, the digital dollar and more continue. And while TradFi and DeFi continue to grow in tandem, a debate is emerging about the extent to which they can learn from and align with each other.   In summary, while the outlook is not yet rosy, there are greenshoots indicating a sustained appetite for and interest in high quality digital asset innovation.

> *Decentralization can help support the resilience of the financial system. Decentralized finance ("DeFi"), enables people to interact with one another through the intermediation of code rather than relying on a financial intermediary such as a bank.*
>
> *Hester Peirce, Commissioner, US SEC, Jan 2023*

Binance's share of the crypto market (%)



Source: CryptoCompare
© FT